BALANCE OF PAYMENTS

Current Issue Review

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BALANCE OF PAYMENTS

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BALANCE OF PAYMENTS*

ISSUE DEFINITION

Shifts in the balance of payments accounts are always topical because they reflect the country's international trading performance and affect the foreign exchange markets. The balance of payments data also affect the perception of our economy on the international scene.

The Canadian economy is very open, both in terms of the share of output traded and the amounts of capital which flow in and out of the country. Since Canada has a relatively small population base and limited domestic capital available, it must look to foreign countries, such as the United States, to meet the nation's capital requirements.

The balance of payments therefore takes on special significance. It constitutes a statement of all transactions between Canada and the rest of the world during a given year. The balance of payments also indicates whether or not the country has sufficient foreign currency (or foreign currency earnings) to cover its liabilities to foreign countries.

BACKGROUND AND ANALYSIS

A. Composition of the Balance of Payments

The main components of the balance of international payments are:

- the current account;
- the capital account; and
- the statistical discrepancy.

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* The original version of this Current Issue Review was published in April 1986; the paper has been regularly updated since that time.

The current account records all receipts and payments from goods and services transactions with foreigners. These transactions are divided into two distinct categories: merchandise trade, that is, exports and imports of physical goods, and non-merchandise trade. This category comprises services (travel, shipping and business services, etc.), investment income (interest and dividends paid with respect to bonds, stocks and other forms of investment capital) and transfers, including foreign aid contributions, personal gifts, etc.

The current account is affected by several factors. It will post a surplus, or the deficit will shrink, if there is an increase in competitiveness (measured by productivity and relative prices, based on the exchange rate) or if economic growth is less vigorous than in other countries, which would lead to lower import growth. Conversely, an economic decline in foreign countries will negatively affect Canada's current account balance, as the market for Canadian goods and services shrinks.

The capital account records Canada's financial transactions with foreign countries, including short-term (1 year or less) and long-term movements of capital. There are two types of capital movements: direct investments in the ownership or control of a business and portfolio investments, which are purchases of company stocks and bonds, both public and private. If a foreign resident purchases a Canadian firm or lends money to the government, a credit, identified by a plus sign, will be recorded in the balance of payments accounting process. In contrast, Canadian residents' purchases of foreign assets are recorded as debits, identified by a minus sign in the balance of payments accounting process.

High interest rates in Canada attract foreign capital while encouraging the various levels of government to borrow abroad. Being more speculative in nature, movements of short-term capital exhibit greater sensitivity to short-term interest rates and to exchange rates.

The statistical discrepancy (or errors and omissions) resolves divergences between the current and capital account balances. A deficit on the current account may be exceeded by a surplus on the capital account and this will be partially reflected by a build-up of official currency reserves (changes in such reserves are recorded in the capital account). If, however, the net capital inflow is less than the current account deficit, official reserves must be drawn upon. To the extent

that fluctuations in official reserves do not equal the difference between the current and capital account balances, an allowance for errors and omissions must be made. Such discrepancies often reflect movements of short term capital which have not been captured by the international financial accounting system. Another source of error is illegal shipments, accounting for which is, of course, difficult. The world as a whole records a balance of payments deficit which is mathematically and theoretically impossible. It can be explained by timing differences in accounting for goods in transit, and the possibility that some countries record illegal payments from other countries as receipts.

In the medium term, the value of current and capital account balances should be nearly equal in order to prevent structural imbalance. A balance of payments "deficit" forces Canadian dollars on the international market, placing downward pressure on the domestic currency. Since official reserves for repurchase of such funds are not unlimited, interest rates are typically raised to attract foreign capital and protect the value of the dollar. High interest rates retard economic growth -- lowering import levels -- and the balance of payments difficulties are thus resolved. The costs of excessive interest rates mount over time (being revealed by a growth rate lower than that of comparable industrial nations). Interest rates that are too low relative to other industrial nations make foreign-source capital difficult to obtain; this, too, retards growth.

B. Evolution of the Balance of Payments Situation

Since the 1950s, the current account has typically been in a deficit position; however, in the early '70s and between 1982 and 1984, it posted a surplus. The two trade surpluses recorded between 1982 and 1984 were undoubtedly caused by the recession, which slowed the import of goods and services. In general, over the period, a surplus was recorded in the merchandise trade balance whereas a substantial deficit was posted in the services and transfers accounts.

The merchandise trade balance surplus and the deficit on services and transfers have both tended to grow since the mid-seventies (see Chart I). The merchandise trade surplus, which

can be attributed largely to exports by the automobile industry as well as energy and forestry products, has usually been overwhelmed by the deficit on services trade and transfers, resulting in a deficit on the current account (see Chart II). The deficit on the services and transfers accounts has usually been caused by large interest payments for outstanding foreign debt.

In 1995, the current account deficit was $11.2 billion, down sharply from the $22.2 billion of the year before, and the lowest level since 1988. Exports increased by $35.9 billion over 1994, while imports increased by $22.4 billion, bringing the merchandise trade surplus up by $13.5 billion above the previous year and to a new record of $28.4 billion. This increase was partially offset by a small increase in the deficit in non-merchandise trade.

The surplus traditionally posted in the capital account (see Chart III) reflects the continuing need of the Canadian economy (and governments) for foreign capital. **In 1995, the capital account showed a surplus of $6.7 billion, a 67% decrease from 1994.** Again this year, the bulk of this investment was channelled into new bond issues of the Canadian provinces and their enterprises, and less so into federal debt issues.

International capital flows are now separated by Statistics Canada into direct investment and portfolio investment. An investment is classified as direct when it allows the investor to influence the management of an enterprise. An ownership level of at least 10% is assumed to provide this ability. Since 1975, increases in Canadian direct investment abroad have been greater than escalations in foreign direct investment in Canada. In fact, Canadian direct investment liabilities to non-residents actually decreased substantially in 1981, 1982 and 1985, while Canadian direct investment claims on non-residents rose substantially.

Portfolio investments are transactions in bonds and stocks (other than direct investment transactions), official international reserves and foreign investments made by Canadian chartered banks. Net purchases of foreign securities are defined here as total purchases of foreign securities minus total sales of foreign securities. **Canadian net purchases of foreign stocks**

amounted to $4.5 billion in 1995, down from the near record $9.3 billion in 1994. On balance, foreigners sold Canadian stocks, the net figure being -$4.2 billion in 1995, compared with +$6.4 billion in 1994, while foreign net purchases of Canadian bonds totalled $29.8 billion, over twice the level of the previous year.

In balancing the current account and the capital account, net fluctuations in official reserves must be taken into consideration before calculating errors and omissions (which came to +$4.5 billion in 1995). Reserves showed an decrease of $3.5 billion in 1995. Reserve fluctuations are caused chiefly by the Bank of Canada's desire to prevent sudden swings in the value of the Canadian dollar. Since 1986, these fluctuations in official reserves have been included in the capital account.

As indicated earlier, one means of compensating for a deficit is to draw down official reserves. Other options open to officials include increasing interest rates in order to attract capital and devaluing the currency to rebalance the current account (this may increase the price level).

Raising interest rates also tends to restrain domestic aggregate demand, thereby lowering import levels and moving the current account towards balance. Restrictive fiscal measures, by curbing domestic demand, may also serve the same end but at some cost to economic growth and employment levels.

In summary:

- The current account has traditionally posted a deficit, primarily because of the services and transfers accounts (particularly interest and dividends payments). However, the increase in the merchandise trade balance was so great between 1982 and 1984 that a surplus was recorded in the current account during this period.

- A surplus has traditionally been recorded in the capital account. However, when errors and omissions in the net movements of short-term capital are taken into account, the capital account surplus is not always large enough to offset the current account deficit, thereby forcing the Bank of Canada to draw upon the official reserves.

In general, capital account surpluses have covered this country's current account deficit. However, capital inflows represent increases in Canadian debt to foreigners and if used simply to finance current consumption, this debt can place an undue burden on future generations. On the other hand, foreign borrowing to finance the building of long-lived capital assets such as hospitals, schools, highways, etc. may yield future benefits greater than the resulting interest payments. Therefore, whether Canada's present balance of payments structure (current account deficit and capital surplus) will leave a net burden for future generations is largely dependent on how wisely these borrowed funds are spent.

C. Statistics Canada Summary

(Taken from the Statistics Canada Daily, 30 August 1996)

Canada's Balance of International Payments
Second Quarter 1996

Highlights

For the first time since the fourth quarter of 1984, Canada generated a current account surplus on a seasonally adjusted basis. In the second quarter of 1996, Canada earned $1.1 billion more than it spent on goods, services, investment income and transfers from abroad. This surplus followed a string of deficits which have been progressively narrowing since the fourth quarter of 1993, largely as a result of a growing surplus on goods.

In financial terms, a current account surplus means that the country invested more capital abroad than it received from foreign markets during the second quarter. Canadian residents acquired foreign portfolio stocks as well as short-term paper and deposits. Canada's international reserves also increased for the second consecutive quarter. At the same time, foreign residents invested a record amount in Canadian stocks and stepped up their purchases of long-term Canadian debt instruments. They withdrew heavily, however, from the Canadian short term market. The Canadian dollar remained quite stable against the United States dollar but strengthened against most major overseas currencies.

CURRENT ACCOUNT

Surplus on goods at an all-time high level

Canada's mainstay surplus on goods climbed to an all-time high of almost $10 billion, $1.5 billion above the previous record set only two quarters ago. The increase in the surplus reflected a combination of higher exports and lower imports. For the fourth consecutive quarter, Canadian businesses increased their sales abroad, concentrating their latest quarterly gains in automotive products, energy products and most machinery and equipment. Importers, at the same time, reduced their requirements, especially of machinery and equipment, following two quarters of higher purchases. This led to a record surplus with the United States and a slightly higher surplus with Japan. Canada saw its deficits widen with the European Union and with all other countries.

The terms of trade, an indicator of how far export earnings cover import outlays, increased slightly during the second quarter. The rise from 109.1 to 109.3 brought the index back to its high at the close of 1995, and in so doing, pointed to a greater relative export strength over the past year than has been indicated since 1989. Gains in volume supported the overall rise in export value compared to the first quarter, while prices eased fractionally. Volume also drove the change in import values, in this case downward. However, lower volume was accompanied by the fourth price decrease in the last five quarters.

Deficit on non-merchandise transactions again moderate

The deficit on non-merchandise transactions declined to $8.8 billion, remaining within the moderate range observed over the previous two quarters. The decline in the current quarter was due to slightly lower deficits on investment income and

on services. Within services, the usual deficit on travel narrowed, as Canadian travellers spent less abroad and foreign visitors continued to increase their outlays in Canada.

CAPITAL ACCOUNT

Usually a net importer of capital, Canada became a net exporter of capital in the second quarter. This was done through Canada's increasing its assets abroad, especially short-term debt instruments, foreign stocks and Canada's international reserves. Canada continued, however, to receive foreign capital, including a record foreign investment in portfolio stocks.

More Canadian investment in foreign stocks

Canadian residents purchased $2.7 billion of foreign stocks, in line with large net investments observed since 1990. The investment in the second quarter was exclusively in overseas (non U.S.) stock. Though on a smaller scale, they have nevertheless been reducing their holdings of foreign bonds over the last three quarters, selling off $0.9 billion in the current quarter.

With lower short interest term rates in Canada, Canadian investors also increased by $3.0 billion their holdings of foreign short term securities and deposits. This was after withdrawing about two-thirds of that amount in the previous quarter. Canada's international reserves rose sharply for a second consecutive quarter by $2.4 billion. The reserves stood at their highest level ever in US funds at $18.5 billion.

Canadian Liabilities to Non-residents

Canadian liabilities increased marginally in the quarter. Increases in portfolio Canadian bonds and stocks and direct investment were largely offset by withdrawals from Canadian money market paper and Canadian banks' net foreign currency liabilities.

Record foreign investment in Canadian stocks

Foreign residents acquired a further $4.5 billion in Canadian stocks, bringing their net investment so far this year to $6.2 billion. This contrasts with their net withdrawal from that market in 1995 but is more in line with the three preceding years of significant foreign investment in Canada. Over 40% of the 1996 investment was channelled into new issues, with the balance invested in outstanding issues.

The United States continued to lead foreign investment in Canadian stocks with significant purchases of resources and communication stocks. The price of Canadian stocks reached a record level as measured by the TSE 300, which surpassed the 5,000 mark.

Large foreign withdrawal from Canadian short term paper

Foreign residents withdrew a total of $7.4 billion in Canadian short-term paper but still invested $5.5 billion in Canadian bonds, both involving largely federal debt instruments. This reflected a large redemption by the federal government of short-term paper and increased longer-term borrowing, notably through the issue of a large U.S. dollar bond. Canadian short-term interest rates during the current quarter were below their US counterparts, an unusual occurrence in the last two decades. In the longer-term market, Canadian rates remained higher than in the United States, but the differential in favour of investment in Canada narrowed to its lowest level in two years.

PARLIAMENTARY ACTION

The Bank of Canada is responsible for managing the balance of payments; this responsibility is not handled directly by the government or by Parliament.

CHRONOLOGY

Current Account

1964-1974 -	Current account deficits, which had never exceeded $1.5 billion, were replaced by small surpluses in 1970, 1971 and 1973.
1975-1979 -	Deficits ranged between $4 billion and $5 billion.
1980-1984 -	Moderate deficits were replaced by moderate surpluses in 1982 through 1984 as lowered income depressed imports.
1985 -	Recorded deficit of $6.2 billion.
1986 -	Recorded deficit of $14.1 billion.
1987 -	Recorded deficit of $15.6 billion.
1988 -	Recorded deficit of $21.1 billion.
1989 -	Recorded deficit of $26.9 billion.
1990 -	Recorded deficit of $25.2 billion.
1991 -	Recorded deficit of $27.0 billion.
1992 -	Recorded deficit of $25.9 billion.
1993 -	Recorded deficit of $28.8 billion.
1994 -	Recorded deficit of $22.2 billion.
1995 -	**Recorded deficit of $11.2 billion**

Capital account

1964-1974 -	The capital account traditionally posted a surplus of between $1 and $2 billion.
1975-1979 -	The surplus increased to range between $6 billion and $8 billion.

1980 - The surplus declined to $2.9 billion.

1981 - Recorded surplus of $15.2 billion (primarily a result of short-term capital inflows).

1982 - Recorded deficit of $443 million.

1983 - Recorded surplus of $6.7 billion.

1984 - Recorded surplus of $7.0 billion.

1985 - Recorded surplus of $12.5 billion.

1986 - Recorded surplus of $16.7 billion.

1987 - Recorded surplus of $18.8 billion.

1988 - Recorded surplus of $21.7 billion.

1989 - Recorded surplus of $26.3 billion.

1990 - Recorded surplus of $26.9 billion.

1991 - Recorded surplus of $30.0 billion.

1992 - Recorded surplus of $24.5 billion.

1993 - Recorded surplus of $38.0 billion.

1994 - Recorded surplus of $20.2 billion.

1995 - Recorded surplus of $6.7 billion.

SELECTED REFERENCES

Bank of Canada. "Canada's Balance of Payments in the 1970s: A Perspective." *Bank of Canada Review*, Ottawa, March 1979.

Statistics Canada. *Canada's International Investment Position.* Publication 67-202 (annual, four-year reporting lag).

Statistics Canada. *Corporations and Labour Union Returns Act - Part I: Corporations.* Publication 61-210 (annual, three-year reporting lag). Contains detailed analysis of foreign ownership control; also breakdown of many professional fees, etc. found in the "other" subaccount of the service section of the current account.

Statistics Canada. *Quarterly Estimates of the Canadian Balance of International Payments.* Publication 67-001 (quarterly, one-quarter reporting lag).

Note: All data in the text and following tables are based on the most recent Statistics Canada publication 67-001 available when this review was updated.

Table 1

Balance of international payments

	Second quarter 1995	Third quarter 1995	Fourth quarter 1995	First quarter 1996	Second quarter 1996	1994	1995
	unadjusted						
	$ millions						
Current account							
Receipts							
Merchandise exports	64,999	60,164	65,517	64,491	68,702	217,936	253,821
Non-merchandise							
Services	9,243	11,383	8,351	7,951	9,724	32,941	36,504
Investment income[1]	3,983	4,450	4,914	4,271	4,311	13,645	17,147
Of which: reinvested earnings	447	604	998	540	683	2,130	2,536
Transfers	1,097	1,210	1,039	1,152	1,199	4,813	4,462
Total non-merchandise receipts	14,323	17,043	14,304	13,374	15,234	51,399	58,113
Total receipts	79,322	77,207	79,821	77,865	83,936	269,335	311,934
Payments							
Merchandise imports	59,142	53,347	55,259	57,861	58,420	203,000	225,431
Non-merchandise							
Services	11,450	11,585	11,162	12,806	12,213	43,454	45,860
Investment income[1]	13,048	11,820	11,134	11,162	11,225	41,124	47,762
Of which: reinvested earnings	2,342	2,052	940	1,033	1,499	2,509	6,693
Transfers	911	971	998	1,098	903	3,927	4,082
Total non-merchandise payments	25,409	24,377	23,294	25,067	24,340	88,505	97,705
Total payments	84,551	77,724	78,553	82,928	82,760	291,505	323,136
Balances							
Merchandise	+5,857	+6,817	+10,257	+6,630	+10,283	+14,935	+28,390
Non-merchandise	-11,086	-7,334	-8,990	-11,693	-9,106	-37,106	-39,591
Total current account	-5,229	-517	+1,268	-5,063	+1,176	-22,170	-11,202
Capital account[2]							
Canadian claims on non-residents, net flows							
Canadian direct investment abroad[1]	-1,736	-271	-4,692	-1,922	-419	-10,157	-7,874
Of which: reinvested earnings	-447	-604	-998	-540	-683	-2,130	-2,536
Portfolio securities							
Foreign bonds	+1,411	-503	+123	+380	+907	+525	-917
Foreign stocks	-519	-1,091	-2,138	-4,099	-2,746	-9,335	-4,509
Government of Canada assets							
Official international reserves	-170	-1,778	+1,340	-2,439	-2,369	+1,630	-3,529
Loans and subscriptions	-324	+60	-98	-182	-293	-1,893	-661
Non-bank deposits abroad	-4,215	-222	-443	+2,080	-3,049	-1,976	-5,108
Other claims	+3,401	+618	+844	+1,207	-1	+4,324	+3,961
Total Canadian claims, net flow	-2,152	-3,188	-5,063	-4,976	-7,970	-16,882	-18,637
Canadian liabilities to non-residents, net flows							
Foreign direct investment in Canada[1]	+2,685	+3,688	+6,774	+2,671	+3,042	+9,945	+14,713
Of which: reinvested earnings	+2,342	+2,052	+940	+1,033	+1,499	+2,509	+6,693
Portfolio securities							
Canadian bonds	+10,311	+11,667	+4,017	+739	+5,527	+14,698	+29,801
Canadian stocks	-1,235	-1,134	-320	+1,679	+4,493	+6,412	-4,242
Canadian banks' net foreign currency transactions with non-resident[3]	-10,762	-11,732	+3,667	-3,667	-3,560	+390	-17,024
Money market instruments							
Government of Canada paper	-3,857	+1,460	-3,718	+3,480	-6,549	+2,731	-2,865
Other paper	+900	-1,582	-183	+1,650	-864	-1,826	-544
Allocation of special drawing rights	-	-	-	-	-	-	-
Other liabilities	+3,423	-1,620	+1,035	-1,465	-534	+4,739	+5,453
Total Canadian liabilities, net flow	+1,465	+748	+11,271	+5,087	+1,555	+37,088	+25,292
Total capital account, net flow	-687	-2,440	+6,207	+111	-6,415	+20,207	+6,654
Statistical discrepancy	+5,916	+2,957	-7,475	+4,952	+5,239	+1,964	+4,547

1 *From 1983, includes reinvested earnings accruing to direct investors.*
2 *A minus sign denotes an outflow of capital resulting from an increase in claims on non-residents or a decrease in liabilities to non-residents.*
3 *When the banks' foreign currency position (booked in Canada) with non-residents is a net asset, series is classified as part of Canadian claims on non-residents.*
- *Nil or zero*

Table 2

Current account

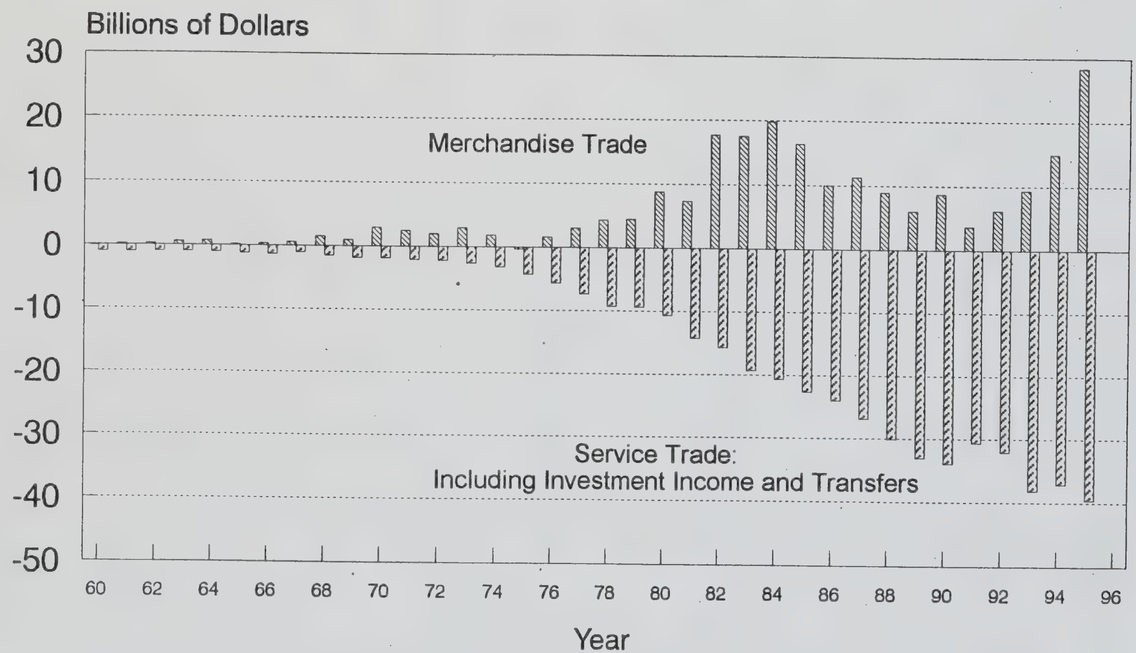
	Second quarter 1995	Third quarter 1995	Fourth quarter 1995	First quarter 1996	Second quarter 1996	1994	1995
	seasonally adjusted						
	$ millions						
Receipts							
Merchandise exports	62,215	62,969	64,620	64,992	66,101	217,936	253,821
Non-merchandise							
Services	8,923	9,118	9,489	9,468	9,427	32,941	36,504
Travel	2,682	2,685	2,896	2,944	3,003	9,730	10,997
Transportation	2,915	2,993	3,030	2,851	2,828	10,374	11,785
Commercial services	3,122	3,244	3,361	3,462	3,386	12,018	12,902
Government services	203	196	202	211	211	820	820
Investment income[1]	4,036	4,237	5,019	4,321	4,388	13,645	17,147
Interest	1,784	1,857	2,014	1,964	1,912	5,052	7,370
Dividends	1,805	1,776	2,008	1,816	1,793	6,463	7,241
Reinvested earnings	447	604	998	540	683	2,130	2,536
Transfers	1,060	1,125	1,082	1,223	1,160	4,813	4,462
Inheritances and immigrants' funds	309	300	311	374	349	1,731	1,279
Personal and institutional remittances	354	379	349	402	363	1,392	1,488
Canadian withholding tax	397	445	421	447	447	1,690	1,695
Total non-merchandise receipts	14,019	14,480	15,590	15,012	14,975	51,399	58,113
Total receipts	76,234	77,448	80,209	80,004	81,076	269,335	311,934
Payments							
Merchandise imports	56,299	55,567	56,160	57,076	56,140	203,000	225,431
Non-merchandise							
Services	11,279	11,552	11,753	12,283	12,036	43,454	45,860
Travel	3,476	3,465	3,597	3,917	3,718	13,697	14,028
Transportation	3,168	3,107	3,232	3,217	3,102	11,430	12,724
Commercial services	4,368	4,705	4,649	4,828	4,916	17,220	18,009
Government services	268	275	275	322	300	1,107	1,100
Investment income[1]	12,552	11,628	11,607	11,217	10,798	41,124	47,762
Interest	9,489	8,562	8,664	8,330	8,157	33,176	35,646
Dividends	1,266	1,455	1,183	1,809	1,650	5,439	5,423
Reinvested earnings	1,798	1,611	1,760	1,077	991	2,509	6,693
Transfers	960	990	1,014	1,045	956	3,927	4,082
Inheritances and emigrants' funds	96	97	98	99	98	362	386
Personal and institutional remittances	357	361	363	373	372	1,363	1,439
Official contributions	425	452	460	493	401	1,871	1,919
Foreign withholding tax	82	81	93	81	85	332	339
Total non-merchandise payments	24,792	24,169	24,375	24,545	23,790	88,505	97,705
Total payments	81,090	79,736	80,535	81,621	79,930	291,505	323,136
Balances							
Merchandise	+5,917	+7,402	+8,460	+7,916	+9,961	+14,935	+28,390
Non-merchandise							
Services	-2,357	-2,434	-2,264	-2,815	-2,609	-10,513	-9,356
Investment income[1]	-8,516	-7,391	-6,588	-6,896	-6,410	-27,479	-30,615
Transfers	+100	+135	+67	+178	+203	+886	+380
Total non-merchandise	-10,773	-9,690	-8,785	-9,533	-8,815	-37,106	-39,591
Total current account	-4,856	-2,287	-325	-1,617	+1,146	-22,170	-11,202

[1] *From 1983, includes reinvested earnings accruing to direct investors.*

Note: *Figures may not add to total due to rounding.*

CHART I

MERCHANDISE AND SERVICE TRADE BALANCE



Source: Statistics Canada, CANSIM Division and the Library of Parliament.

CHART II
CURRENT ACCOUNT BALANCE

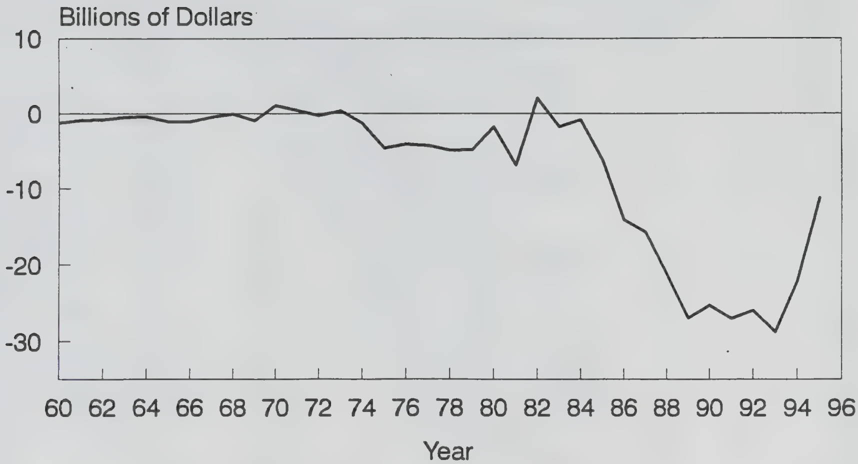
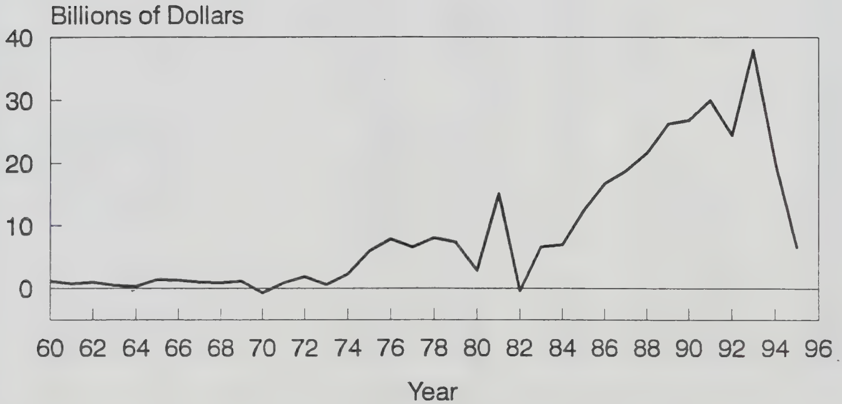


CHART III
CAPITAL ACCOUNT BALANCE



Source: Statistics Canada, CANSIM Division and the Library of Parliament.